Office of Chief Counsel Internal Revenue Service

memorandum

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EWJohnson

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to: Paul Ferber, International Examiner

from: Associate Area Counsel, LMSB, St. Paul

subject: Application of Reorganization Statutes to Foreign Restructuring Distribution

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This memorandum is in response to your request for advice of March 30, 2000, as supplemented on June 29, 2000, and on various later dates.

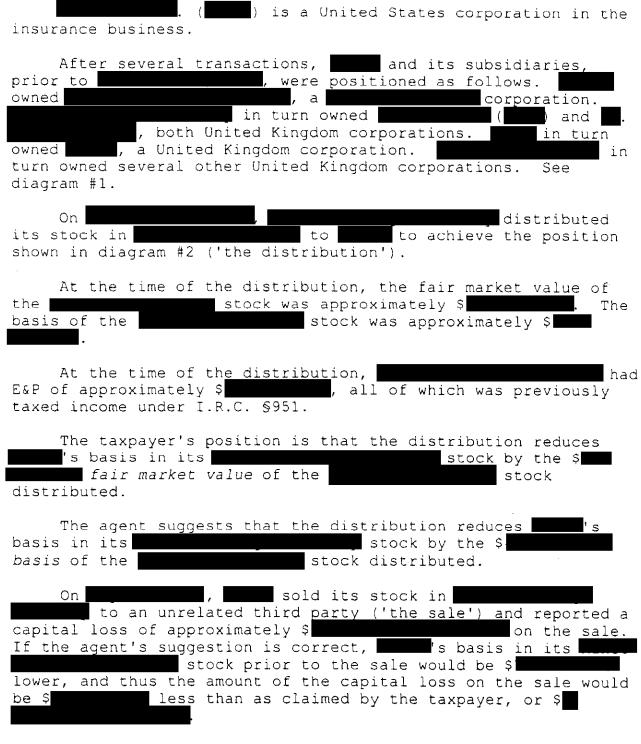
ISSUE

Whether under the facts provided the distribution of stock of a controlled corporation by a corporation without taxable E&P to its shareholder reduces the shareholder's basis in the stock of the distributing corporation by the fair market value or by the basis of the stock in the distributed corporation.

CONCLUSION

The shareholder's basis in the stock of the distributing corporation is reduced by the fair market value of the stock in the distributed corporation.

FACTS



The distribution was made as one of a series of steps taken in contemplation of the sale.

DISCUSSION

Where property other than money is distributed by a corporation, the amount of the distribution is the fair market value of the property. I.R.C. \$301(b)(1).

A distribution is a taxable dividend to the shareholder only to the extent of E&P. I.R.C. $\S\S301(c)(1)$, 316(a). A distribution in excess of E&P is a return of capital; the shareholder does not have taxable income, but the stock basis is reduced by the distribution. I.R.C. $\S301(c)(2)$.

If a distribution is made out of E&P, but the E&P is previously taxed income under I.R.C. §951, again the shareholder does not have taxable income, but the stock basis is reduced by the distribution. I.R.C. §§959(a), 961(b)(1).

In this case it is agreed that, without regard to the reorganization statutes, the distribution would reduce basis in by the \$4 fair market value of the stock distributed as claimed by the taxpayer, because had no taxable E&P at the time of the distribution.

The agent suggests that application of the reorganization statutes requires that s basis in its stock is reduced by the \$ basis of the stock distributed as opposed to the \$ fair market value.

The reorganization statutes are not applicable in this case.

The appropriate reorganization statute for consideration on these facts is I.R.C. §355, which involves treatment of a corporate distribution of a controlled subsidiary. Application of I.R.C. §355 requires 'continuity-of-interest', which means that the distributing and the distributed corporations must remain substantially in the control of the persons that owned the distributing corporation prior to the distribution. See, Reg. \$1.355-2(c). The step-transaction doctrine applies in determining whether there is continuity-of-interest, e.g. if the distribution is made in contemplation of later sale of the

In the facts provided there was also mention of significant significant specificant specif

distributing or distributed corporation to an unrelated third party, there is no continuity-of-interest. <u>McDonalds Restaurants of Illinois, Inc. v. Commissioner</u>, 688 F.2d 520 (7th Cir. 1982).

In this case, the distribution was made in contemplation of the eventual sale of the distributing corporation to an unrelated third party. There is no continuity-of-interest, and thus no application of I.R.C. §355.

In any case, application of I.R.C. §355 would not lead to the result suggested by the agent. The flush language of I.R.C. §355(a) essentially states that the distribution is not a taxable dividend, and although the point is not directly addressed in the statute, in the case of a distributing corporation without taxable E&P, the logical conclusion is that there is no corresponding 'return-of-capital' reduction in the shareholder's basis in the distributing corporation on the distribution. 2

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² <u>See</u>, Reg. 1.358-1 Example (where I.R.C. §355 distribution in excess of E&P, no mention of reduction of basis for such excess, except to the extent of recognized boot). There might be some reduction in some is basis in its stock because some of this basis would be reallocated to the stock, but such a reduction is computed without reference to the basis of the stock prior to the distribution. <u>See</u>, I.R.C. §358; Reg. §1.358-1 and -2.